STATE & LOCAL TAX ALERT

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Quarterly California Tax Legislation Update

January 2014 - March 2014

Dear Friends & Clients,

The purpose of this Quarterly California Tax Legislative Update is to provide our clients and prospective clients with timely and meaningful updates that affect both their personal income and business taxes.

The first quarter of 2014 was a relatively quiet time in California from a tax legislative perspective. The Franchise Tax Board ("FTB") upheld its position that pretty much all income in California should be treated as apportionable business income based on a Superior Court ruling that a merger termination fee is apportionable business income in California. The State finally dealt with the inability of companies to reduce or eliminate a Deferred Intercompany Stock Account ("DISA") by passing legislation allowing for the elimination or reduction of a DISA under certain circumstances. Finally, a new assembly bill attempts to once again redefine change of ownership for real property tax purposes.

Superior Court Rules that Termination Fee is Apportionable Business Income

In 1999, Comcast attempted to acquire MediaOne. The contract included a provision for liquidated damages of $1.5 billion, which MediaOne paid to Comcast upon terminating the contract and merging with another company. Comcast treated the termination fee income as non-business income allocated to Comcast's headquarters outside of California. In determining whether or not the income was apportionable business income, the FTB used the "transactional" and the "functional" tests as required under California law. The "transactional test" involves determining whether the income arises from a transaction occurring within the normal course of business, considering the regularity of similar transactions. The FTB argued the merger termination fee income paid to Comcast was apportionable business income under the "transactional test" because it was derived from an acquisition agreement that Comcast entered into regularly as the company consistently made acquisitions. The "functional test" treats income as business income if the acquisition, management and disposition of the related property are an integral part of the regular business. The FTB asserted that the acquisition agreement was intangible property rights that Comcast acquired, managed and disposed of as part of its regular business. The court sided with the FTB's assertions.

The take away here is that income derived from activity that is regularly engaged in, whether or not income is regularly received from that activity, can be considered apportionable business income in California and highlights the State's position on unique revenue streams such as merger termination fees.

Amended Regulation Passed Allowing for the Reduction of a DISA

Effective April 1, 2014, Deferred Intercompany Stock Accounts ("DISA") may be reduced and/or eliminated with the passing of amendments to California Code of Regulations ("CCR") section 25106.5-1. CCR section 25106.5-1 is California's intercompany combined reporting regulation.

DISAs are formed in California when intercompany distributions exceed the basis in the distributor's stock. Prior to the passing of the amendments to CCR section 25106.5-1, a DISA could not be eliminated or reduced in California and income was recognized equal to the DISA when either the stock holder or entity who's stock was held left the California combined return either through a sale, merger or liquidation.

The amendments to CCR section 25106.5-1 provides for treatment of DISAs similar to the treatment provided in Treasury Regulation section 1.1502-19 for Excess Loss Accounts (ELA). This allows capital contributions to reduce DISAs and reduce subsequent gain to be recognized. Prior to amendment, the regulation did not allow for reduction of a DISA through capital contributions and all gain would have to be recognized at the time the DISA was triggered (either all at once or spread out over a 60-month period). The amendment also clarifies that merger of brother/sister corporations does not trigger a DISA. Furthermore, distributions at various levels of stock ownership will not create multiple DISAs.

The amendment is retroactive to intercompany transactions that occurred on or after January 1, 2001 and prospectively. As reported in prior quarterly tax legislative update, it is required of taxpayers to track and report DISAs on California returns. Given the amendments, it would be prudent to look at previously reported DISAs and revise according to these new changes.

New Assembly Bill Redefines Change of Ownership that Triggers Property Tax Reassessment

Assembly Bill 2372 is very similar to Assembly Bill 188, which was introduced and discussed in last year's legislative updates. A.B. 188 died in committee, but its successor proposes:

- "Change of ownership" in real property held by a legal entity will occur when 100 percent of a legal entity's interest is transferred or sold within a three-year period. This event triggers property tax reassessment.
- Transfer of ownership interests may be accomplished by "merger, acquisition, private equity buyout, transfer of partnership shares or any other means."
- "Change in control" is not a requirement to have a "change of ownership." Control occurs when more than 50 percent of voting stock or ownership interest is owned directly or indirectly by one person or entity.
- Change of ownership interest in an entity that owns real property, including leasehold interests, must be reported to the State Board of Equalization within 90 days of the date of change. It is unclear if this means every time a percentage of interest is transferred there will be a reporting requirement.
- A deed must be recorded with the county recorder after a change of ownership interest in an entity that owns real property, even if the owner of the real property does not change. It is unclear if this means every time a percentage of interest is transferred a deed will need to be recorded.
- Subsequent to proportional property transfers, which are excluded from calculating change of ownership, any transfers of interests must be reported to the assessor within 90 days.
- Failure to file Form 100-B with the SBE within 90 days of change of ownership will result in increased penalty of 20 percent (from previous 10 percent).

The likelihood of the passing of this assembly bill is uncertain and Green Hasson Janks will provide updates as they occur. &

Contact Us:

Akash Sehgal
Director
310.873.1622
asehgal@greenhassonjanks.com

Morgan Morrissey
Senior Associate
310.873.1681
mmorrissey@greenhassonjanks.com

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